Before the
Federal Communications Commission
Washington, D.C. 20554

In the Matter of

Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers	))))	WC Docket No. 03-173

REPLY COMMENTS OF THE AD HOC TELECOMMUNICATIONS USERS COMMITTEE

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SUMMARY

The Ad Hoc Telecommunications Users Committee ("Ad Hoc") supports the Commission's long-standing efforts to bring competition to local exchange and exchange access markets, and believes that the Commission's network unbundling and interconnection rules, including the "Total Element Long Run Incremental Cost" ("TELRIC") framework, remain crucial to that process. As explained in these Reply Comments, Ad Hoc believes that the TELRIC framework generally has been functioning as intended, to produce prices for unbundled network elements ("UNEs") that permit efficient entry by competitive local exchange carriers ("CLECs") and fairly compensate the incumbent local exchange carriers ("ILECs") for use of their facilities. Ad Hoc urges the Commission to reject efforts to undermine regulatory requirements that have created opportunities for competition to develop in local service markets. Accordingly, the Commission should not revise its TELRIC rules at this time.

The detailed changes tentatively proposed in the Commission's NPRM spawned thousands of pages of responses from all sectors of industry, most notably the ILECs and CLECs. AdHoc's response to those myriad Comments is limited to two fundamental areas: the major thematic criticisms of the existing TELRIC methodology levied by the ILECs and proposals made by the ILECs for changes to the existing mechanism and inputs.

The comments filed in this proceeding do not provide any basis for concluding that the Commission's TELRIC methodology in place today requires fundamental revision. A review of the record indicates that:

- *There has been no evidence introduced that use of the current TELRIC methodology has caused a decline in telecommunications investment.* One of the central themes of the Commission's Notice is a concern that the existing TELRIC methodology discourages both ILECs and CLECs from making new network investments by understating the true level of forward-looking costs for provision of UNEs which results in "below cost" prices for UNEs. There has been no evidence introduced that the current TELRIC Methodology has caused a decline in telecommunications investment.

- *Purported evidence that the existing TELRIC Methodology does not produce a valid relationship between UNE prices and cost is flawed.* RBOC contentions that the TELRIC methodology has been producing UNE price levels that are, on the one hand, below cost and, on the other hand, vary widely and without regard to underlying costs are not supported by credible evidence. On their face, these two claims appear mutually contradictory. Either the TELRIC regime has been producing UNE prices that are too low, *i.e.,* below cost, or it has been producing UNE prices that vary without regard to cost, but it cannot have done both at the same time. Moreover, the RBOCs' complaints that TELRIC produces rates that are "below cost" reflect a fundamental misinterpretation of the purpose of TELRIC-based pricing. The costs against which they are measuring TELRIC are various forms of embedded costs, *i.e.,* costs as reflected on the ILECs' books rather than economic costs. This comparison begs the very question posed by the Commission in this proceeding, *viz.*, whether UNE prices should reflect historic embedded costs or forward-looking costs.

- *The RBOC's proposed changes to the TELRIC methodology would essentially revert to a reproduction cost model.* The RBOCs generally advocate replacing TELRIC with a costing approach that would be tied much more closely to each individual ILEC's present and near-term anticipated network design and incurred costs. While some RBOCs refer to this approach as producing "actual forward-looking costs," it is in fact a variant of the discredited reproduction cost method, not a forward-looking replacement costing method.

Given the fundamentally flawed criticisms that the ILECs have levied against the Commission's TELRIC methodology, Ad Hoc agrees with the Iowa Utilities Board's view that "the FCC's effort [to revise its existing TELRIC methodology] thus far seems to be a solution in search of a problem." The road to making local exchange markets competitive has been an arduous one for all industry participants – the ILECs, the new entrants, the Commission and other regulators, and the consumers of services who are ultimately intended to be the beneficiaries of the competitive framework, in the form of better services, more rapid innovation, and lower prices. Given the key role that the Commission's TELRIC framework has played in realizing those hard-won gains in local competition, and its demonstrated validity as a pricing methodology for network unbundling and interconnection, the Commission should stay the course and refrain from revising TELRIC in a manner that could undermine that progress.

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REPLY COMMENTS OF AD HOC TELECOMMUNICATIONS USERS COMMITTEE

The Ad Hoc Telecommunications Users Committee (the "Ad Hoc Committee" or "Ad Hoc") submits these Reply Comments pursuant to the Notice of Proposed Rulemaking ("*Notice*" or "*NPRM*") in the above-referenced docket.[1]

INTRODUCTION

The members of the Ad Hoc Telecommunications Users Committee ("Ad Hoc" or "the Committee") are among the nation's largest users of telecommunications services and facilities. While they provide a variety of goods and services, and represent a broad range of industry sectors, Ad Hoc's member companies share a common attribute: the success of their businesses depends significantly upon the availability of reliable, innovative, and competitively-priced

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[1] *Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers*, CC Docket No. 03-

telecommunications services. Ad Hoc has no members who are carriers and, though its positions may occasionally coincide with those of carriers, it advocates only those public policy and regulatory outcomes that protect the interests of end users by fostering competition where it is possible and relying on regulation only where it is not.

The Committee supports the Commission's long-standing efforts to bring competition to local exchange and exchange access markets, and believes that the Commission's network unbundling and interconnection rules, including the "Total Element Long Run Incremental Cost" ("TELRIC") framework, remain crucial to that process. As explained in these Reply Comments, Ad Hoc believes that the TELRIC framework generally has been functioning as intended, to produce prices for unbundled network elements ("UNEs") that permit efficient entry by competitive local exchange carriers ("CLECs") and fairly compensate the incumbent local exchange carriers ("ILECs") for use of their facilities. Ad Hoc urges the Commission to reject efforts to undermine regulatory requirements that have created opportunities for competition to develop in local service markets. Accordingly, the Commission should not revise its TELRIC rules at this time.

DISCUSSION

As explained in detail below, the comments filed in this proceeding do not provide any basis for concluding that the Commission's Total Element Long Run

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173, Notice of Proposed Rulemaking, 18 FCC Rcd 18945 ("*Notice*").

Incremental Cost ("TELRIC") methodology in place today requires any fundamental revisions. Accordingly, the Commission should confirm that the TELRIC framework remains sound and refrain from adopting any changes that would unreasonably disassociate UNE prices from economic costs.

I. No Party Has Proffered Evidence That The Current TELRIC Methodology Discourages Telecommunications Investment.

One of the central themes of the Commission's Notice is a concern that the existing TELRIC methodology discourages both ILECs and CLECs from making new network investments by understating the true level of forward-looking costs for provision of UNEs which results in "below cost" prices for UNEs. As expressed early in the Notice:

> To the extent that the application of our TELRIC pricing rules distorts our intended pricing signals by understating forward-looking costs, it can thwart one of the central purposes of the Act: the promotion of facilities-based competition. While our UNE pricing rules must produce rates that are just, reasonable and nondiscriminatory, consistent with the Act's goal of promoting sustainable competition, they should not create incentives for carriers to avoid investment in facilities.[2]

Not surprisingly, the RBOCs have seized on this concern and unanimously condemn the Commission's TELRIC-based UNE pricing methodology for discouraging network investments.[3] However, the evidence proffered by the

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[2] *Notice* at para. 3**,** footnote omitted.

[3] *See* BellSouth Comments at 9; SBC Comments at 7-13; Qwest Comments at 3-6; Verizon Comments at 8-19.

RBOCs does not support their claim that network investment has declined as a result of TELRIC-based pricing of UNEs.

Verizon claims that "[o]bjective evidence demonstrates that TELRIC sends incorrect economic signals to all carriers" and has "created significant disincentives to investment…"[4] In support, Verizon relies on a Declaration by the economists Thomas Hazlett, Arthur Havenner, and Coleman Bazelon.[5] But that Declaration in turn relies upon and incorporates another Declaration by the same economists (referred to as "*HHB 2203*" by Verizon) that was originally filed in WC Docket No. 03-157, *Petition for Forbearance From the Current Pricing Rules for the Unbundled Network Element Platform*.[6]

In *HHB 2003*, Dr. Hazlett, *et al.,* explain that changes in investment in the telecommunications industry can be measured by evaluating *net capital stock*, which for LECs can be approximated by calculating the total book value of plant and equipment, minus accumulated depreciation.[7] Dr. Hazlett, *et al.,* then present a chart, Figure 3, that purports to show that the RBOCs' net capital stock dropped sharply in 2002 and is now "down approximately 12 percent – $13 billion

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4 Verizon Comments at 8.

5 Declaration of Thomas W. Hazlett, Ph.D., Arthur M. Havenner, Ph.D., and Coleman Bazelon, Ph.D. (December 15, 2003), provided as Exhibit 3 to Verizon Comments in the instant docket ("*Hazlett et al. December 15th Declaration*").

6 *Petition for Forbearance From the Current Pricing Rules for the Unbundled Network Element Platform,* WC Docket No. 03-157, Declaration of Thomas W. Hazlett, Ph.D., Arthur M. Havenner, Ph.D., and Coleman Bazelon, Ph.D. (September 2, 2003), provided as Attachment 4 to Exhibit 3 to Verizon Comments filed in the instant docket ("*HHB 2003*").

7 *HHB 2003* at para. 10.

– since enactment of the 1996 Telecommunications Act."[8] While the Declarants also cite third-party pronouncements by analysts in the financial sector, Figure 3 is the Declarant's principal direct evidence in support of their "disinvestment" claim.

In reality, Dr. Hazlett, *et al.,* have relied upon an overly-aggregated data series from the FCC's ARMIS database that does not accurately represent net capital stock, especially for recent years. Moreover, when a more precise estimate of net capital stock is derived from the same data sources, the results contradict their claim.

The Declarant's error stems from their use of the Average Net Investment values reported in the ARMIS database (ARMIS Report 43-01). As the Declarants freely admit,[9] Average Net Investment is a highly aggregated number that not only takes into account gross Total Plant In Service ("TPIS") and accumulated depreciation and amortization, but also a variety of other costs that are not for actual plant assets, including:

- Deferred Operating Income Taxes
- Customer Deposits
- Other Deferred Credits
- Deferred Tax Liabilities; and
- Other Long-Term Liabilities

Because these costs generally are not relevant to the determination of the amount of an ILEC's operating plant or other productive assets, they should not

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[8] *HHB 2003* at para. 20.

[9] *HHB 2003* at para. 16, footnote 5.

be included in a calculation of net capital stock for the purpose of assessing network investment. Moreover, in the case of the RBOCs those costs are so high that they render the Average Net Investment data series that the Declarants relied upon invalid for purposes of estimating net capital stock. In particular, Other Long-Term Liabilities as reported in ARMIS (and rolled into the Average Net Investment numbers) for BellSouth, SBC, and Verizon in aggregate are zero until year 2000, when they jump to the $12-billion range; thereafter, they account for between twelve and sixteen percent of total Average Net Investment. Because Other Long-Term Liabilities are non-plant costs, their inclusion in the numbers cited by Dr. Hazlett *et al.* pulls down the Average Net Investment values reported for 2000-2002, and creates a spurious impression that net capital stock for those RBOCs has decreased.

Figure 1 below illustrates the effect of correcting for this error, by comparing the Average Net Investment values for 1995-2002 presented by Dr. Hazlett *et al.,* with the same series adjusted by removing Other Long-Term Liabilities. As Figure 1 demonstrates, this correction alone produces a very different picture from that relied upon by the Declarants, and invalidates their conclusions concerning net capital stock.[10]

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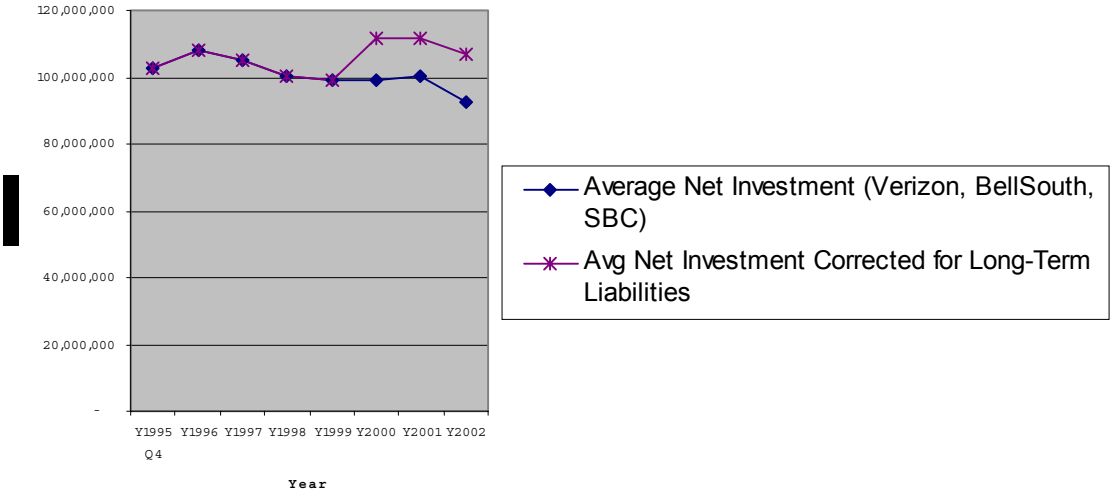
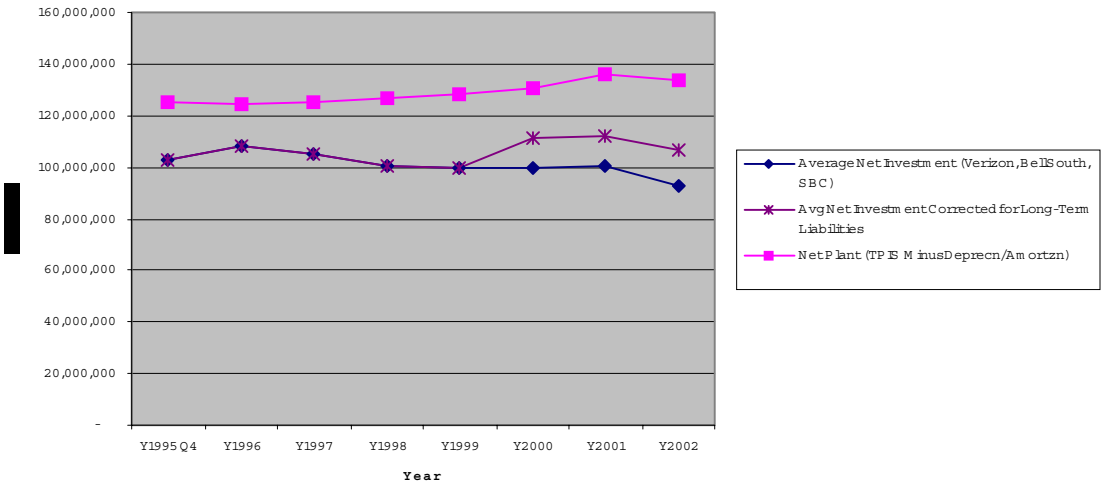
[10] Given the major impact of Other Long-Term Liabilities, it is striking that the Declarants described their version of Average Net Investment as a "rough measure" because it "includes a number of items that are not directly related to network investments, such as Deferred Tax Liabilities and other Long-Term Liabilities," but failed to appreciate how that entirely invalidates their conclusions. *See HHB 2003* at para. 16, footnotes 5 and 6.

Figure 1. Average Net Investment (Verizon, BellSouth, SBC) Corrected to Remove Long-Term Liabilities



A reasonably accurate estimate of net capital stock also requires, however, removal of the other non-relevant cost categories listed above and a focus on net plant in service, which can be determined more directly by subtracting accumulated depreciation and amortization from Total Plant in Service ("TPIS"). Figure 2 below presents total Net Plant in Service for BellSouth, SBC, and Verizon over the same period, together with the two series from Figure 1. As with Figure 1, the data was drawn directly from the ARMIS database (Report 43-01).

Figure 2. Net Plant in Service (Verizon, BellSouth, SBC)



Not only is the Net Plant in Service series shown in Figure 2 generally higher than either of the Average Net Investment curves (mainly due to the absence of Deferred Operating Income Taxes), it rose every year between 1996 and 2001, for a cumulative increase of 9.1% over that period. Instead of the $8-billion drop in Average Net Investment from 2001 to 2002 cited by the Declarants,[11] a more accurate assessment reveals that Net Plant in Service declined by only $2-billion, or 1.5 percent, in 2002, and thus remained at the second-highest level since passage of the 1996 Telecommunications Act. Simply put, the "Net Capital Stock" analysis presented by the Declarants is fundamentally flawed while a properly specified analysis reveals that there is no "investment crisis" occurring in the telecommunications industry.

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[11] *HHB 2003* at para. 20 (compare Figure 3 values for 2002 and 2001).

The Declarants have also challenged other economists concerning a series of econometric studies conducted by the Phoenix Center that purport to show that TELRIC, and TELRIC-based pricing of UNE-P in particular, has actually stimulated, rather than discouraged, additional network investment by the BOCs.[12] The controversies are fairly technical in nature and remain unresolved at this point. Ad Hoc urges the Commission to review the Phoenix Center study as part of the formal record for this proceeding.[13] It is noteworthy that, given the importance that the RBOCs attach to this issue, the only econometric studies identified on the record thus far support a finding that investment has been stimulated under the Commission's existing TELRIC methodology. No one, including the Declarants, has proffered an econometric study supporting the proposition that TELRIC has dampened ILEC investment.[14]

Among other parties who have commented on this investment incentives issue, it is particularly noteworthy that Sprint Corporation, which has significant ILEC operations as well as long distance and cellular holdings, also disputes the

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[12] *HHB 2003*, Appendix, "An Economic Analysis of Phoenix Center Policy Bulletin No. 5, Competition and Bell Company Investment in Telecommunications Plant: The Effects of UNE-P" (July 9, 2003); *Hazlett et al. December 15 Declaration* at 8-10, and Appendix 2, "Evaluating the Analysis in Phoenix Center Policy Bulletin No. 5 and in Phoenix Center Policy Bulletin No. 6," *responding to* Phoenix Center Policy Bulletin No. 5: Competition and Bell Company Investment in Telecommunications Plant: The Effects of UNE-P (original release July 9, 2003, updated September 17, 2003), and Phoenix Center Policy Bulletin No. 6: UNE-P Drives Bell Investment – A Synthesis Model (September 17, 2003), http://www.phoenix-center.org

[13] Phoenix Center Policy Bulletin Nos. 5 and 6, *id.*

[14] Dr. Hazlett *et al.,*. are careful to point out that, although they have constructed alternatives to the Phoenix Center's econometric models, "[t]hese models do not, by themselves, prove a negative relationship between UNE-P and ILEC investment. Instead, they demonstrate that the data do not support the results asserted by the Phoenix study." *HHB 2003*, Appendix at 9.

RBOCs' claims concerning investment and its relationship to TELRIC. Sprint concludes that "[t]he BOCs have not shown that TELRIC discourages investment" and that "no BOC has proven that TELRIC has distorted economic incentives."[15]

Moreover, Sprint observes that the recent decline in overall telecommunications investment is not attributable to TELRIC but to other factors that "include, principally, an economic downturn that has had particular impact on the telecommunications industry, a particularly severe downturn in the CLEC industry, and the burst of the Internet bubble."[16] Ad Hoc agrees with this assessment. RBOC economists who fault TELRIC for RBOC investment decisions ignore or greatly underestimate the impact of these other factors.[17]

The RBOC economists also rely too heavily upon relatively dated financial information (predominantly from end-of-year 2002) that does not necessarily reflect economic conditions prevailing now or in the near-term future. They ignore recent indications that the overall health of the economy is improving. In the third quarter of 2003, for example, GDP increased at an annual rate of 8.2%,

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15 Sprint Comments at 9.

16 Sprint Comments at 9-10.

17 *See, e.g., HHB 2003* at para. 29-30.

fueled by personal consumption expenditures and equipment and software.[18] This was the largest increase in GDP in the last two decades.[19]

They also fail to address more recent indications that the telecommunications industry is recovering from its recent downturn and that the capital expenditures of telecommunications companies are rebounding. On January 12th of this year, for example, Business Week reported that:

> The telecom downturn is over. U.S. telecom companies are expected to increase capital expenditures, a crucial measure of industry health, by 5% in 2004, to $58 billion in 2004, according to Lehman Brothers Inc. (LEH) analyst Steven Levy. That's the first increase since 2000, and it's a welcome turn of events, even though the increase restores spending only to 1996 levels. [20]

Moreover, the RBOCs are continuing to announce significant network upgrade programs. In August of 2003, Verizon announced an ambitious initiative to deploy a fiber-optic network that would reach every residential and business customer in its 29-state territory over the next 10-15 years, at an estimated cost of $20- to $40-billion.[21] Most recently, in January of 2004, Verizon announced that it would invest $3-billion over the next two years to upgrade its broadband network.[22] Ivan Seidenberg, Verizon's chairman and chief executive officer,

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[18] Bureau of Economic Analysis, United States Department of Commerce, *News Release: Gross Domestic Product and Corporate Profits*, BEA 03-52, December 23, 2003. Available at http://www.bea.gov/bea/newsrel/gdpnewsrelease.html, (accessed January 28, 2004).

[19] "Economic and Financial Indicators: Overview", *The Economist* (November 27, 2003).

[20] Steve Rosenbush, "Telecommunications: strong signals the bad times are over", *BusinessWeek* (January 12, 2004).

[21] Steve Rosenbush, "Verizon's gutsy bet", *BusinessWeek* (August 4, 2003).

[22] "Verizon will spend $3B to upgrade broadband network", *Telecommunications Reports* (January 15, 2004).

recently proclaimed that "Verizon has invested $55-billion in infrastructure since 2000 – more capital than almost anyone in America…."[23] Verizon's gloomy portrayal of wireline telecommunications investment in its Comments[24] appears to be at odds with what Verizon management is actually doing.

II. The Commission's TELRIC Methodology Produces a Valid Relationship Between UNE Prices and Cost

In addition to the investment disincentive argument discussed above, a second major challenge to the Commission's TELRIC methodology in this proceeding has been that the methodology generates UNE prices with a flawed relationship to cost. The RBOCs in particular make two claims in support of this position.

First, they contend that TELRIC has been producing UNE price levels that are below cost.[25] As expressed by Verizon, "TELRIC produces rates that are lower than the costs that incumbents incur today and that do not emulate the prices that would be produced in a real-world competitive market."[26] SBC also devotes considerable attention in its Comments to this argument and offers a supporting economic analysis,[27] while Qwest echoes this position.[28]

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23 *Id.*

24 *See, e.g.,* Verizon Comments at ii.

25 As discussed further below, the RBOCs offer several different definitions of "cost" as the relevant one.

26 Verizon Comments at 4.

27 SBC Comments at 7-11, and Exhibit A, Debra J. Aron, Ph.D. & William Rogerson, Ph.D., *The Economics of UNE Pricing,* (December 16, 2003) ("*Aron/Rogerson*").

At the same time, the RBOCs assert that the state PUCs have not followed the TELRIC rules consistently, so that they have been setting UNE rates at levels that vary widely and without regard to underlying costs. Verizon alleges that "the rates set under TELRIC varied widely among different states for reasons that do not correspond to cost differences."[29] Similarly, SBC's economic consultants maintain that:

> …as we have explained, there should be a systematic relationship between actual costs and forward-looking costs, and we would not expect it to vary wildly across states. The fact that UNE prices vary substantially in ways that are unexplained by these cost proxies reinforces our view that state commissions exercise their discretion in ways that are random with respect to costs.[30]

On their face, these two claims appear mutually contradictory: the TELRIC regime has been producing UNE prices that are too low, *i.e.,* below cost, or it has been producing UNE prices that vary without regard to cost, but it cannot have done both at the same time.

Nor do these claims withstand closer examination. The Aron/Rogerson analysis purporting to show that state PUCs are setting UNE rates arbitrarily relative to costs is deficient in several respects.

First, that analysis is not based at all upon an evaluation of the particular cost evidence used by each state PUC to determine TELRIC-based rates, but instead compares the results of state PUC proceedings with three "cost proxies"

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[28] Qwest Comments at 6.

[29] Verizon Comments at 7.

[30] *Aron/Rogerson* at 36.

derived from other sources.[31] But only one of those proxies, access line density, can be characterized as a reasonable driver of the level of forward-looking costs that TELRIC would produce. The other two are cost estimates, one being an estimate of the embedded costs of UNE-P that the analysis develops from ARMIS data and the second being the FCC's cost estimates for universal service fund ("USF") purposes generated by the so-called Hybrid Cost Proxy Model ("HCPM").[32] Neither estimate can be expected to track the results of a TELRIC analysis precisely, as the authors admit.[33] Nevertheless, when evaluating the results of their analysis, they impose a standard of near-perfection, anticipating that "the model's adjusted R-squared value should be close to one."[34] It is therefore unsurprising, and equally uninformative, that their results do not reach that standard.

More to the point, taken at face value, the regressions' results lead to just the opposite conclusion. The fact that the regression against access line density (Regression 3) produced an adjusted R-squared value of 0.38 – meaning that 38% of the variability in TELRIC results can be explained by that one cost driver – supports the notion that TELRIC *does* reasonably reflect underlying drivers of costs. If the authors had added additional cost drivers, such as state labor rate

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31 *Aron/Rogerson* at 35.

32 *Id.* at 35.

33 *Id.* at 36, noting that "we recognize that none of the cost proxies we identify are perfect proxies for forward-looking cost…" See also pages 34-35, discussing the likely variation between embedded cost and forward-looking cost.

34 *Id.* at 35.

differentials, differences in demand levels, etc., then presumably such regressions could show an even tighter correlation between cost conditions and TELRIC-based rates.

Moreover, the RBOCs' claims that TELRIC produces rates that are "below cost" reflect a fundamental misinterpretation of the purpose of TELRIC-based pricing. The costs against which they are measuring TELRIC are various forms of *embedded* costs, *i.e.,* costs as reflected on the ILECs' books rather than economic costs.[35] This comparison begs the very question posed by the Commission in this proceeding, *viz.,* whether UNE prices should reflect historic embedded costs or forward-looking costs.

Indeed, in the original *Local Competition Order*,[36] the Commission considered a wide range of costing approaches, including embedded costs, and adopted a forward-looking economic costing methodology.[37] In doing so, it expressly rejected ILEC claims that UNE pricing should allow for recovery of their embedded costs.[38] In the Commission's words:

> We are not persuaded by incumbent LEC arguments that prices for interconnection and unbundled network elements must or should include any difference between the embedded costs they have incurred to provide those elements and their current economic costs. Neither a methodology that establishes the prices for

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35 *See, e.g., Aron/Rogerson* at 28-32.

36 *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996 and Interconnection Between Local Exchange Carriers and Commercial Mobile Radio Service Providers*, CC Docket Nos. 96-98 and 95-185, First Report and Order, 11 FCC Rcd 15499 (1996) ("*Local Competition Order*").

37 *Id*. at 15817-15821.

38 *Id.* at 15857-15859.

> interconnection and access to network elements directly on the costs reflected in the regulated books of account, nor a price based on forward looking costs plus an additional amount reflecting embedded costs, would be consistent with the approach we are adopting. The substantial weight of economic commentary in the record suggests that an "embedded cost"-based pricing methodology would be pro-competitor – in this case the incumbent LEC -- rather than pro-competition. We therefore decline to adopt embedded costs as the appropriate basis of setting prices for interconnection and access to unbundled elements. Rather, we reiterate that the prices for the interconnection and network elements critical to the development of a competitive local exchange should be based on the pro-competition, forward-looking, economic costs of those elements, *which may be higher or lower than historical embedded costs*. Such pricing policies will best ensure the efficient investment decisions and competitive entry contemplated by the 1996 Act…[39]

The Commission's analysis and finding at that time was sound, and it has remained so to the present day, despite repeated legal challenges to the Commission's decision to adopt the TELRIC methodology.[40] Consequently, regardless of whether the TELRIC vs. embedded cost comparisons advanced by the Drs. Aron and Rogerson and other RBOC-sponsored economists are correct or flawed, they are fundamentally irrelevant to an assessment of the legitimacy of the particular TELRIC methodology adopted by the Commission, and the RBOCs' criticisms of TELRIC based on these analyses are specious.

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[39] *Id*. at 15857-15858 (citations omitted, emphasis supplied).

[40] *See, Verizon Communications Inc., et al. v. Federal Communications Commission, et al.*, 535 U.S. 467 (2002).

III. The RBOC Alternatives to TELRIC Revert to the Discredited Reproduction Cost Methodology

The RBOCs generally advocate replacing TELRIC with a costing approach that would be tied much more closely to each individual ILEC's present and near-term anticipated network design and incurred costs.[41] While some RBOCs refer to this approach as producing "actual forward-looking costs,"[42] it is in fact a variant of reproduction cost method than a forward-looking replacement costing method.

In a reproduction cost calculation, the aim of the analysis is to determine how much it would cost to re-build the existing network today from scratch, assuming the same network design, components, and technologies appearing in that network.[43] For example, if a particular feeder route in an ILEC's network contained five copper cables, each consisting of 300 line pairs, then the analysis would calculate the costs for feeder along that route by determining today's cost for installing five 300-pair copper cables. In contrast, a true forward-looking replacement cost approach instead would evaluate the total demand along that feeder route (assuming that the route and switch location served are not optimized further), and determine the costs of the most efficient cable configuration and technology that could be installed today to serve that demand. Thus, in this example, the feeder route might be more efficiently served today

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41 *See, e.g.,* BellSouth Comments at 14-15; SBC Comments at 29-35; Verizon Comments at 35-39; Qwest Comments at 19-20, 30-32.

42 SBC Comments at 24.

43 *See, e.g., Notice* at para. 69, footnote 112.

using a 1200 pair cable plus a 300 pair cable or, if the least-cost solution has shifted to optical fiber due to technological progress, the latter would be assumed for economic costing purposes. The replacement cost analysis would assume the latter cable configuration, and because larger cables or properly scaled fiber tend to have significantly lower per-pair costs than smaller cables, the analysis would reflect those scale economies by producing a lower cost level than under the reproduction cost analysis.[44]

As the Commission itself observed in the *Notice*, the reproduction cost approach "generally has been discredited."[45] One CLEC economist, Dr. Willig, has succinctly explained why in a Declaration attached to AT&T's comments in this proceeding:

> Finally, the notion that UNE rates should be based on the costs of reproducing the incumbent's existing network in its current configuration and technology mix is also unacceptably inconsistent with economics. This is a measure of reproduction cost—the cost of reproducing the particular physical assets that happen to be in the ground today. The forward-looking cost of the actual ILEC network, however, is not the cost of reproducing or cloning that actual network, but the cost of reproducing its *capabilities*, using the most efficient technology available today. Because telecommunications technology advances over time, forward-looking cost is likely to be substantially below reproduction cost. In a competitive market, no one would pay a premium to purchase an old inefficient network over a new and efficient network of equivalent capability.[46]

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[44] For the purposes of illustration, we have assumed that copper cable remains least-cost for the given feeder route; it is also possible the least-cost solution has shifted to optical fiber due to technological progress, in which case the latter should be assumed for economic costing purposes.

[45] *Notice* at para. 69, footnote 112.

[46] AT&T Comments, Declaration of Robert D. Willig at para. 68 (December 16, 2003) (footnotes and citations omitted) ("*Willig Declaration*").

SBC argues that its proposed "actual forward-looking" costing approach differs from the pure (and discredited) reproduction cost methodology because it would be based on forward projections to the network in place mid-way through the ILEC's planned network upgrades over the next three years. The evaluation of costs would therefore take into account any technological evolution and efficiency improvements that would occur over that time.[47] However, this sort of hybrid costing approach appears to fail both on a conceptual level and in practical implementation.

First, as a conceptual matter, recognizing incremental changes to the network would not remove for costing purposes the potential inefficiencies embedded in the portions of the legacy network that were not planned to be replaced. To illustrate, consider that we wished to determine the forward-looking costs for a mid-size automobile. Suppose that our existing car was a 1999 Ford Taurus, and we planned to replace the tires, but nothing else, in the next three years. Under SBC's approach, we would model "actual forward-looking" costs by combining the cost to purchase a replacement set of tires, with the cost to purchase a 1999 Ford Taurus, excluding the cost of its original-equipment tires. Of course, assuming that we could actually obtain an unused[48] 1999 Ford Taurus

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47 SBC Comments at 31-32.

48 A used car's purchase price generally falls over time to reflect accumulated depreciation, and thus would not be suitable to apply for a forward-looking analysis. SBC appears to recognize this point also, see SBC Comments at 33 (the forward-looking cost should not be the undepreciated amount remaining on the ILEC's books).

today, it would fail to reflect any of the technological improvements and/or cost reductions that have occurred for mid-size cars over the past five years, *e.g.* better fuel economy, safety features, all-wheel drive, etc. Instead, this approach would lock in nearly all of the 1999-era performance and (relative to today's standards) inefficiencies. Accordingly, the result of such a modeling exercise would fall well short of the type of forward-looking replacement scenario needed to evaluate forward-looking economic costs.

Second, on the implementation level, projecting forward eighteen months (*i.e.,* midway through a three-year planning horizon) would be unlikely to change significantly most ILECs' embedded stock of plant, particularly for the long-lived loop-related network facilities that are arguably most crucial to CLEC entry into local service markets. Indeed, to the extent that the RBOCs prove to be correct that they and other ILECs are making significant cut-backs in their capital expenditures (whether due to TELRIC's incentives or other factors),[49] one would expect SBC's approach to be even less distinguishable from the discredited reproduction cost methodology because, by reducing capital expenditures, the ILECs reduce their opportunities to make efficiency-enhancing changes to their network plant.

Applying an eighteen-month look-ahead period does, however, create new uncertainties and disputes that a TELRIC methodology avoids. As legitimately forward-looking as it is, TELRIC does not require any forecasting of future

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[49] *See, e.g.*, Verizon Comments at 9-10.

changes in demand, productivity, inflation, or other variables because it evaluates costs "today" rather than within some future time frame. As SBC admits, its approach would require "adjustments for inflation and productivity improvements that the incumbent actually expects to achieve during the planning period."[50] And while SBC does not appear to recognize that demand shifts might also occur in that timeframe,[51] its costing approach would in fact require some forecast of the ILEC's future demand as well. In these respects, the "actual forward-looking cost" approach would be more speculative, controversial, and uncertain than the Commission's TELRIC methodology.[52]

CONCLUSION

Given the fundamentally flawed criticisms that the ILECs have levied against the Commission's TELRIC methodology, Ad Hoc agrees with the Iowa Utilities Board view that "the FCC's effort [to revise its existing TELRIC methodology] thus far seems to be a solution in search of a problem."[53] The state regulatory commissions, via the National Association of Regulatory Utility Commissioners ("NARUC"), have stated that "because TELRIC pricing has

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50 SBC Comments at 28.

51 SBC assumes that it could "take as given" existing customer locations, without any consideration of the demand growth or decline that presumably would be a factor in the ILEC's three-year engineering plans. SBC Comments at 28.

52 It is worth noting that SBC's position rebuts the suggestion by the Competitive Enterprise Institute (see Comments of the Competitive Enterprise Institute at 8) that it would be appropriate for costing to incorporate "some projected cost data from as far ahead as five years." As SBC states, "Because ILECs do not generally plan most network upgrades more than three years in advance, expanding the planning period beyond three years would reintroduce precisely the counterfactual speculation that the Commission seeks to avoid in this proceeding." SBC Comments at 32, footnote 41.

53 Iowa Utilities Board Comments at 1.

withstood Court challenge and has been a factor in encouraging and sustaining local competition thereby benefiting consumers, NARUC encourages the FCC to retain its use."[54] Moreover, NARUC, as well as some individual state PUCs, has cautioned against the temptation to fix any perceived problems with TELRIC implementation in certain cases by means that would be overly prescriptive to the states.[55] As expressed by the Pennsylvania Public Utilities Commission:

> The Commission should not reduce the establishment of rates by State commissions to a 'fill in the blank' exercise that eliminates the exercise of informed judgment. Having adopted a forward-looking economic cost methodology, the Commission should refrain from further mandates. This "less is more" approach preserves the role of State commissions to actually establish rates.[56]

It has been nearly a decade since the passage of the Telecommunications Act of 1996, and there can be no dispute that the road to making local exchange markets competitive has been an arduous one for all industry participants – the ILECs, the new entrants, the Commission and other regulators, and the consumers of services who are ultimately intended to be the beneficiaries of the competitive framework, in the form of better services, more rapid innovation, and lower prices. Given the key role that the Commission's TELRIC framework has played in realizing those hard-won gains in local competition, and its demonstrated validity as a pricing methodology for network unbundling and

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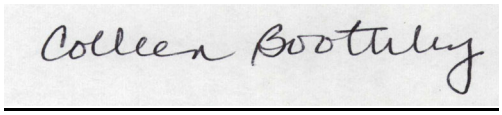
54 NARUC Comments at 1.

55 *Id*.

56 Pennsylvania PUC Comments at 3.

interconnection, the Commission should stay the course and refrain from revising TELRIC in a manner that could undermine that progress.

Respectfully submitted,
AD HOC TELECOMMUNICATIONS USERS COMMITTEE

By: 

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January 30, 2004

Certificate of Service

I, Michaeleen I. Williams, hereby certify that true and correct copies of the preceding Comments of Ad Hoc Telecommunications Users Committee were served this 30th day of January, 2004 via the FCC's ECFS system, and by first class mail upon the following:

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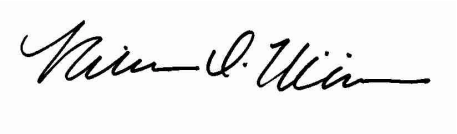

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January 30, 2004